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No. 86-

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1986

HARRISON J. GOLDIN, Comptroller of the City of New York, and THE CITY OF NEW YORK,

Petitioners,

-against-

JAMES BAKER, Secretary of the Treasury of the United States,

Respondent.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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April 10, 1987

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OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DATED AND ENTERED JANUARY 12, 1987

No. 391 - August Term, 1986
(Argued: December 1, 1986
Decided: January 12, 1987)
Docket No. 86-6150

HARRISON J. GOLDIN, Comptroller of the City of New York, and THE CITY OF NEW YORK,

Plaintiffs-Appellants,

-against-

JAMES BAKER, Secretary of the Treasury of the United States,

Defendant-Appellee.

Before:

FEINBERG, Chief Judge, NEWMAN and MINER,

Circuit Judges.

Appeal by New York City from judgment of the United States District Court for the Southern District of New York, Vincent L. Broderick, J., dismissing its complaint. The

City claimed that a federal tax provision violated the intergovernmental tax immunity doctrine. Affirmed.

BARRY P. SCHWARTZ, New York, NY, Assistant Corporation Counsel of the City of New York (Frederick A.O. Schwarz, Jr., Corporation Counsel of the City of New York, Leonard Koerner, Fay Leoussis, Assistant Corporation Counsel, of Counsel), for Plaintiffs-Appellants.

FREDERICK M. LAWRENCE, New York, NY, Assistant United States Attorney for the Southern District of New York (Rudolph W. Giuliani, United States Attorney for the Southern District of New York, Nancy Kilson, Assistant United States Attorney, of Counsel), for Defendant-Appellee.

FEINBERG, Chief Judge:

This case requires us to examine the scope of the intergovernmental tax immunity doctrine. Plaintiffs Harrison J. Goldin, Comptroller of the City of New York, and the City (collectively referred to herein as

the City) appeal from a judgment of the United States District Court for the Southern District of New York, Vincent L. Broderick, J., denying the City's motion for summary judgment and granting the motion of defendant Secretary of the Treasury to dismiss the City's complaint for failure to state a claim upon which relief can be granted. The City challenges the constitutionality of section 86 of the Internal Revenue Code of 1954 as amended, 26 U.S.C. § 86, Pub. Law 98-21 § 121, 97 Stat. 65 (1983).[1] The City contends that section

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[1]Section 86 provides, in relevant part, as follows:

§ 86. Social security and tier 1 railroad retirement benefits

(a) In general. - Gross income for the taxable year of any taxpayer described in subsection (b) (notwithstanding section 207 of the Social Security Act) includes social security benefits in an amount equal to the lesser of -

(1) one-half of the social security

(Footnote Continued)

86 effectively places a tax on municipal bond interest and therefore violates the intergovernmental immunity doctrine and the Tenth Amendment of the United States

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(Footnote Continued)

benefits received during the taxable year, or

(2) one-half of the excess described in subsection (b)(1).

(b) Taxpayers to whom subsection (a) applies. -

(1) In general. - A taxpayer is described in this subsection if

(A) the sum of

(i) the modified adjusted gross income of the taxpayer for the taxable year, plus

(ii) one-half of the social security benefits received during the taxable year, exceeds

(B) the base amount.

(2) Modified adjusted gross income. - For purposes of this subsection, the term "modified adjusted gross income" means adjusted gross income -

(A) determined without regard to this section and sections 221, 911, 931, and 933, and

(B) increased by the amount of interest received or accrued by the taxpayer during the taxable year which is exempt from tax.

(Footnote Continued)

Constitution. Because we think section 86 is constitutionally sound, we affirm.

In 1983, Congress enacted section 86 in order to tax a portion of the social security benefits received by persons who have substantial income from other sources. See House Conf. Rep. No. 47, 98th Cong., 1st Sess. 122-23, reprinted in 1983 U.S. Code Cong. & Ad. News 404, 412-13. Section 86 requires that, if a taxpayer's "modified adjusted gross income" plus one-half of his

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(Footnote Continued)

(c) Base amount. - For purposes of this section, the term "base amount" means -

(1) except as otherwise provided in this subsection, $25,000,

(2) $32,000, in the case of a joint return, and

(3) zero, in the case of a taxpayer who -

(A) is married at the close of the taxable year (within the meaning of section 143) but does not file a joint return for such year, and

(B) does not live apart from his spouse at all times during the taxable year.

social security benefits exceeds a certain "base amount," a portion of the taxpayer's social security beneifts shall be included in his taxable income. The amount included in taxable income is either (i) one-half of the social security benefits received or (ii) one-half of the amount by which his modified adjusted gross income plus one-half of his social security benefits exceeds his base amount, whichever is less. The base amount is $32,000 for taxpayers filing joint returns and $25,000 for most other taxpayers. In determining a taxpayer's modified adjusted gross income, section 86 includes "interest received or accrued by the taxpayer during the taxable year which is exempt from tax." 26 U.S.C. § 86(b)(2)(B). It is this last proviso that gives rise to the controversy before us.

The Secretary's excellent brief offers two examples to illustrate the operation of section 86.

> Taxpayer A, who files a joint return, has an adjusted gross income . . . of $29,000. He received $2,000 in tax-exempt interest income and $5,000 in Social Security benefits. To compute A's "modified adjusted gross income," add his tax-exempt interest income ($2,000) to his adjusted gross income ($29,000). Thus, his "modified adjusted gross income" is $31,000. Section 86 applies to A only if this sum plus one-half of his Social Security benefits exceeds the base amount of $32,000. In this example, A's "modified adjusted gross income" ($31,000) plus one-half of his Social Security benefits ($2,500) totals $33,500, and exceeds his base amount by $1,500. Some portion of his Social Security benefits is thus taxable. Because one-half of the excess ($750) is less than one-half of the total Social Security benefits received, the taxpayer would be required to include $750 from his Social Security benefits in his gross income for purposes of computing his taxable income.
>
> Taxpayer B, who files a joint return, has an adjusted gross income of . . . $35,000. He also received $2,000 in tax-exempt

interest income and $5,000 in Social Security benefits. B's "modified adjusted gross income" is thus $37,000; when added to one-half of his Social Security benefits, the total is $39,500, which exceeds his base amount by $7,500. Some portion of his Social Security benefits is thus taxable. Because one-half of his Social Security benefits ($2,500) is less than one-half of the excess, only one-half of his Social Security benefits is included in gross income for purposes of computing taxable income.

Thus, for certain taxpayers (like taxpayer A), the effect of section 86 can be as follows: If they have interest income from tax-exempt municipal securities, a portion of their social security benefits will be taxed. On the other hand, if that tax-exempt income did not exist, their social security benefits would be taxed to a lesser degree or not at all. This effect of section 86 operates on a fairly narrow group of taxpayers. Nonetheless, it could make municipal securities marginally less attractive to investors and thereby increase the

interest rate the City has to pay to attract lenders. The City contends that section 86 is a tax on interest income from municipal securities and that it threatens the City's ability to provide essential services by impairing the City's ability to borrow money.

In support of its claim that section 86 violates the intergovernmental immunity doctrine, the City relies on Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, modified on rehearing, 158 U.S. 601 (1895). In Pollock, the Supreme Court held a federal statute imposing a tax on income from municipal bonds to be unconstitutional, see 157 U.S. at 583-86. Whether the rule of Pollock has survived the ninety years since it was announced is questionable, see South Carolina v. Regan, 465 U.S. 367, 404-15 (1984) (Stevens, J., dissenting). The passage of the Sixteenth Amendment to the Constitution in 1913 and numerous Supreme

Court decisions since that time have cast doubt on the vitality of Pollock. We need not face this question, however, since we find that section 86 is not a tax on interest paid by the City.

By its terms, section 86 is part of a tax on social security income. Judge Broderick correctly pointed out that the tax is intended to strengthen the social security system by requiring "taxpayers who have a comfortable flow of income" to pay a tax on part of their social security benefits. See S. Rep. No. 23, 98th Cong., 1st Sess. 25-28, reprinted in 1983 U.S. Code Cong. & Ad. News 143, 166-69. Admittedly, tax-exempt municipal bond income will, in certain cases, affect this new tax on social security benefits. However, that by itself does not make section 86 a direct tax on municipal bond income.

Indeed, in United States v. Atlas Life Ins. Co., 381 U.S. 233 (1965), the Supreme Court upheld a statute that, like section 86, required certain recipients of tax-exempt income to pay a larger tax than they would have paid had they not received the tax-exempt income. In Atlas, the Court was presented with a statute that required life insurance companies to allocate a pro rata share of all their income, tax-exempt or otherwise, to their reserves. The reserves were required in order to guarantee payment to policyholders. Income placed in the reserves was not taxed. Rather than include a pro rata share of its tax-exempt income in its reserves, the insurance company naturally preferred to attribute none of its tax-exempt income to the mandatory reserve deposits; using regular income for this purpose would reduce its tax bill by decreasing the amount of taxable

income remaining after it took its reserve deduction. In an argument similar to that advanced by the City here, the company contended that the statute, as applied, was unconstitutional because an insurance company that received tax-exempt income from "investing its 'idle' assets in municipal bonds" would be subject to a greater tax than an insurance company that did not make "the additional investment at all." 381 U.S. at 250. The Supreme Court firmly rejected this view, adopting instead "the principle of charging exempt income with a fair share of the burdens properly allocable to it." 381 U.S. at 251. The Court concluded that an added burden on tax-exempt income did not constitute a tax on that income.

Furthermore, Pollock has not been a barrier to taxes on the profits from the sale of municipal bonds, Willcuts v. Bunn, 282 U.S. 216 (1931), or to estate taxes on their

transfer at death, Greiner v. Lewellyn, 258 U.S. 384 (1922). Section 86 is merely another example of a federal tax that makes a municipal security marginally less attractive - here, to some persons who also receive social security benefits. A taxpayer who does not receive such benefits is affected only remotely, if at all, by section 86, even if the taxpayer owns municipal bonds. In short, section 86 is not a tax on income from that type of security.

The City argues that even if the narrow rule of Pollock does not cover this case, the broader principles of intergovernmental immunity underlying Pollock require us to invalidate the statute. We disagree. The origins of intergovernmental tax immunity lie as far back as McCulloch v. Maryland, 4 Wheat. 316 (1819), and Collector v. Day, 11 Wall. 113 (1871). The policy behind the doctrine is

restricted to insuring that a federal tax does not destroy the state's ability to function:

> [T]he Court was concerned with the continued existence of the states as governmental entities, and their preservation from destruction by the national taxing power. The immunity which it implied was sustained only because it was one deemed necessary to protect the states from destruction by the federal taxation of those governmental functions which they were exercising when the Constitution was adopted and which were essential to their continued existence.

Helvering v. Gerhardt, 304 U.S. 405, 414 (1938).

Because federal taxes that place indirect burdens on states and municipalities have not generally implicated this policy, the intergovernmental immunity doctrine has not been a bar to a broad array of taxes at least as burdensome on states and municipalities as section 86, e.g., Willcuts v. Bunn, 282 U.S. 216 (tax on profits from sale of municipal bonds); Greiner v. Lewellyn, 258

U.S. 384 (tax on transfer of municipal securities after death); Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926) (tax on income of independent contractor earned from contracts with a state); Helvering v. Gerhardt, 304 U.S. 405 (tax on salaries of employees of state-controlled corporation). Simply put, "an economic burden on traditional state functions without more is not a sufficient basis for sustaining a claim of immunity." Massachusetts v. United States, 435 U.S. 444, 461 (1978).

The Court stated as long ago as Willcuts v. Bunn, 282 U.S. at 225:

> The power to tax is no less essential than the power to borrow money, and, in preserving the latter, it is not necessary to cripple the former by extending the constitutional exemption from taxation to those subjects which fall within the general obligation of non-discriminatory laws, and where no direct burden is laid upon the governmental instrumentality, and there is only a remote, if any, influence upon the exercise of the functions of government.

Section 86, which is a tax on social security benefits, imposes just this kind of indirect burden. See Shapiro v. Baker, No. 84-2492, slip op. (D.N.J. Nov. 5, 1986). The intergovernmental immunity doctrine does not apply.

The City's argument that section 86 violates the Tenth Amendment of the United States Constitution merits little discussion. The Tenth Amendment provides:

> The powers not delegated to the United States by the Constitution nor prohibited by it to the States, are reserved to the States respectively, or to the people.

The City claims that section 86 impairs its "ability to function effectively in a federal system," citing Fry v. United States, 421 U.S. 542, 547 n.7 (1975). Such a drastic view of section 86 is totally unsupportable. Moreover, "[b]ecause the power to tax private income has been expressly delegated to Congress, the Tenth Amendment has no

application to this case." South Carolina v. Regan, 465 U.S. at 418 (Stevens, J., dissenting).

Accordingly, the judgment of the district court is affirmed.

JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

HARRISON J. GOLDIN, Comptroller of The City of New York, and THE CITY OF NEW YORK,

Plaintiffs,

-against-

JAMES BAKER, Secretary of The Treasury of the United States,

Defendant.

JUDGMENT
85 Civ. 7788 (VLB)

For reasons set forth on the record on July 23, 1986, the complaint is dismissed for failure to state a claim for which relief can be granted, and the plaintiffs' motion for summary judgment is denied.

Dated: New York, New York
September 12, 1986

United States District Judge

DECISION OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

HARRISON J. GOLDIN, Comptroller of The City of New York, and THE CITY OF NEW YORK,

Plaintiffs,

-against-

JAMES BAKER, Secretary of The Treasury of the United States,

Defendant.

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85 Civ. 7788 (VLB)

July 23, 1986
11:57 o'clock am

Before:
HON. VINCENT L. BRODERICK,
District Judge

APPEARANCES

NEW YORK CITY LAW DEPARTMENT
OFFICE OF THE CORPORATION COUNSEL
BY: ALEXANDRA S. BOWIE and
MICHAEL D. YOUNG,
Attorneys for plaintiffs

UNITED STATES ATTORNEY
BY: FREDERICK M. LAWRENCE,
Assistant United States Attorney
Attorney for defendant

THE COURT: The first question which I must consider is that of the standing of the plaintiffs to bring this action. The tax which is under attack, 26 USC Section 86, is a tax which impinges directly upon a small segment of the total universe that receives social security payments, and the direct effect of the tax, when it is applicable, is to require the members of that small segment to pay a tax upon a part of the social security payments which they have received. The income from municipal bonds which they own will play a role in placing them in the taxable bracket.

At first blush, therefore, it would seem to be these affected taxpayers and not the Comptroller of the City of New York or the City of New York itself who have standing.

The plaintiffs have, however, alleged a direct impact which this tax has or may have on them. Thus, the complaint alleges that

the City of New York is heavily dependent on funds which are raised by the sale of bonds to finance capital projects and notes to finance current operations. It alleges that these municipal securities have been purchased by elderly taxpayers who have invested because, among other things, of their expectation that the interest from those municipal bonds and notes will be free of tax.

It alleges that the impact of Section 86 has been to cause many of these elderly investors to refrain from investing in municipal securities, as a result of which the City is losing an important segment of the market for its securities.

It further alleges that the loss of these elderly citizens as investors will harm the City and the City's residents. The City will be forced, according to the complaint, to pay higher interest, and the combination of

the loss of participants in the market and the increased cost of money will mean that fewer funds will be available to fund capital projects and to provide essential services.

The City, in substance, characterizes the tax provided by Section 86 as being a tax on municipal bonds. I do not accept that characterization, but I am satisfied that the City has alleged a direct impact upon itself from this tax and a prospective impact in the future which is sufficient to warrant its invocation of the jurisdiction of this court.

The government has argued that the impact alleged is conjectural, and it may very well be that if we proceeded to the development of a detailed record, it would be found to be without substantial foundation.

I am now dealing, however, with a complaint, the allegations of which, for purposes of this ruling, I accept as true,

and that complaint alleges distinct injury to the City of New York and it is injury that would certainly be corrected by a favorable decision.

During the colloquy this morning I discussed the Atlas case. There are certainly many differences between this case and the Atlas case. One of them is that the arguments made in the Atlas case, with respect to the impact of the use of the allocation of tax exempt income in the determination of insurance company taxation, were made by the taxpayer and not by any issuer of tax exempt bonds.

While the city in this case has apparently been solicited by various individual taxpayers to take up the cudgels, the continued vitality of tax exemption for municipal bonds that is being urged is certainly in its own interest.

It is arguable that the City's interest here is a long-term interest in preserving the integrity of the tax exempt status of its bonds and notes and that that interest should be urged in Congress rather than in the courts, but the issue it raises is a direct constitutional issue, and in my judgment is appropriate to be heard in this court.

In sum, I find that the City and Mr. Goldin, as the comptroller of the City, have standing in this action. That finding with respect to standing is not, however, a finding with respect to anything more than the plaintiff's [sic] right to raise the constitutional issue.

I now pass to the government's motion to dismiss the complaint.

The tax provided for by Section 86 is a tax on social security payments received by a taxpayer. However that tax is measured,

if a taxpayer owning municipal bonds does not receive social security payments, he will not be subject to the tax. Tax exempt income comes into play as a factor to be considered in determining the total flow of income to that taxpayer. It goes into the computation of whether the taxpayer is pushed into a bracket which will require that he pay some part of his income tax to be measured by social security payments.

The argument of the plaintiffs is that there is a constitutional doctrine of intergovernmental tax immunity which prevents the national government, directly or indirectly, from taxing municipal securities.

Plaintiff relies [sic] on the Pollock case and a long line of cases antecedent to Pollock. There is, of course, a progression from the time of Pollock to the present time which has served considerably to narrow the

concept in practice of intergovernmental tax immunity.

There was a time when the federal government could not constitutionally tax the salaries of state officials, just as state and city governments could not constitutionally tax the salaries of federal officials. To date there has been no direct inroad into the constitutional prohibition against taxation of municipal bonds as to income, but it is clear today that the transfer of such bonds by gift or testamentary device [sic] is subject to tax, and any capital gains on the sale of municipal bonds is subject to tax.

It is also clear today that commercial business enterprises of a state may be subject to federal income taxation.

In short, the development of the law since the time of Pollock has been to permit substantial inroads into the once mighty wall

of separation between federal and state activities.

This background may or may not be directly germane to the question before me because here we do not have any effort by the federal government to tax directly the income from municipal bonds.

We have, instead, the effort by the federal government to deal with a real and pressing problem of recent years, to wit: The rather shaky financial status of the social security system.

The thrust of Section 86 is to require taxpayers who have a comfortable flow of income to pay a tax on some part of the social security payments which they receive.

There is a cap on the income tax attributable to social security that they must pay. Whatever their financial situation, they need not pay tax on more than 50 percent of the social security benefits received.

Municipal bond income comes into the picture with respect to a measure of the total income flow. This scarcely constitutes the tax imposed by Section 86 as being a tax on tax exempt income.

The burden placed upon plaintiffs by operation of the Section 86 tax structure may be a substantial one. It is scarcely more substantial than the burden which was placed upon states and municipalities by the determination that the salaries of their employees were subject to federal tax.

Here the plaintiffs argue that the impact will be to raise the cost of money to the city. The decision to permit the federal taxation of city and state employees which was determined to be constitutionally permissible substantially raised the cost of city and state government.

In sum, recogizing that there may be a fairly substantial impact upon the plaintiffs

from the operations of the tax imposed under Section 86, I find that that is an impact which is constitutionally permissible.

I grant the defendant's motion to dismiss the complaint, and I deny the plaintiffs' motion for summary judgment.